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Brexit

Europe as we know it is disintegrating. In the latest version of the "shot heard 'round the world" by way of popular vote, citizens of the United Kingdom decided they had seen enough of the experiment to create a United States of Europe, better known as the European Union(EU). The 'Brexit' outcome's surprise and significance sent the global financial markets into short-term chaos, with the British Pound suffering its largest one-day decline in history, stock markets around the world falling as much as double-digit percentages; while high quality government bonds and gold soared on flight-to-safety buying. The panic lasted only a few days, with global equity markets staging rapid recoveries, expecting a new round of liquidity from central banks.

Almost immediately, economists cut their growth forecasts for the UK and Europe, with some suggesting the slowdown will span the globe. Others proclaimed the end of globalization, and the beginning of the end of Europe. It's a long leap to this conclusion, all based on the vote tally for a non-binding resolution. It also serves as a reminder that representative government is superior to pure democracy. Giving every Tom, Dick and Harry direct and equal say in a nation's political economy is not an especially bright idea. As an insightful anecdote, reportedly the most commonly-searched term in the UK was "what is the European Union?"; most searched that is, on the day following the vote. Nothing like shooting first, asking questions later.

The European Union arose from the ruins of World War II, with a goal of securing an enduring peace through economic and political cooperation. The six founding nations included Belgium, France, Germany, Italy, Luxembourg and the Netherlands. By the year 2000, the EU had established its principles of 'four freedoms' -- movement of goods, services, people and money -- while many of its members had also adopted the Euro as a common currency. Today the EU is comprised of 28 member nations, with a population over 500 million, and has broadened its scope to include a European Parliament, Court of Justice, and Central Bank.

When the history is written, Brexit will foremost be a political story. The UK's ruling Tory party is already seeking a new leader, who will become Prime Minster this autumn. The Labor party overwhelmingly voted 'no-confidence' in its own leader, while the head of the UK Independence Party announced his resignation. If the UK exits Europe, Scotland will need to choose between membership in the European Union, or remaining within the United Kingdom. The former seems more sensible. That will leave England -- not so much Britain anymore -- as a smaller, more isolated version of its former nation; taking fewer directives from Brussels-based rule-makers, while sacrificing influence of its neighbors and largest trading partners. Paramount to those who voted to leave the EU, it will also tighten England's borders. Other countries will be tempted to follow suit, holding similar referendums on splitting from the European Union, and economic nationalism may become the prevailing theme in Europe. The core of Europe, of which the UK should have been considered an integral part, must decide whether reforms in governance and immigration policy are in order. This may be a stretch. History says un-elected bureaucrats are skilled at imposing regulations and collecting paychecks, not so much at compromise and self-reflection.

How deeply Brexit cuts into the European, or world, order, is a matter of opinion. To some observers, England stands above the EU, doesn't need it, and no longer belongs. To others, unified Europe was already in decline; the British vote simply shines a spotlight on the problem.

Still others took the vote as a cautionary signal. As summarized by Credit Suisse shortly following the Brexit vote:

"What we think this vote does constitute, though, is evidence that western electorates are disillusioned by globalization. The UK has voted to leave the EU, a reversal of the growing breadth and depth of Europe's single market. This does not look particular to the UK. Most European countries have seen growing support for anti-system parties of either the far left and far right. And in the US, candidates expressing skepticism over free trade and globalization performed very well in the primaries for this year's Presidential election. This may well prove the trend for politics in the west for many more years. If so, it would likely prove negative for economic growth and corporate profitability."

Then again, so far all we have is a narrow margin of victory in a non-binding referendum. When the time is right, the UK's new leadership will invoke Article 50 of the Treaty of European Union, initiating a two-year negotiation of exit terms. Or perhaps the new leadership will have second thoughts, and a watered-down compromise will emerge. "Brexit means Brexit" is no rallying cry. Cooler heads might decide that voting to leave the EU was a national act of self-flagellation, while carrying out the threat runs the risk of lasting damage.

If Brexit will be foremost a political story, it begins as a vote and quickly turns into an economic event. Markets do not wait for thoughtful historians. The reaction to the Brexit referendum is understandable, and magnified by the vote's surprising outcome. It goes something like this:

Conditions change overnight. With the UK now on a path to exit the European Union, the UK's economic outlook is tenuous. Uncertainty itself is an economic depressant, as it leads to retrenchment by consumers and businesses.

This lowers UK growth expectations and makes its currency vulnerable to capital outflows. The British pound is trading at a 31-year low and Wall Street forecasts are being revised on the fly, cutting growth expectations for the UK and Europe.

The world is a global marketplace, and the flight to safety will not be confined to the UK and Europe. High quality sovereign bond yields will plummet, as capital seeks safety in a buying frenzy. Gold will likewise benefit, again seen as a safe haven. Periphery Europe will be viewed as more problematic, with increased odds of fracturing into pieces in the coming years. All the PIGS -- Portugal, Italy, Greece, and Spain -- pose risks to economic stability. Those risks are being re-evaluated by market participants on a continuous basis. Throughout Europe, economic nationalism will set in. Nations crave self-determination, including the right to control their borders, print money, and devalue their currencies. This threatens the future of the Euro currency, which was always an accident waiting to happen**.**

In the wake of this 'risk off' trade, global equities and commodities will suffer a short-term shock. In financial parlance, risk premiums around the world will rise, reflecting heightened tension and possibly slower growth. This lowers prices for most risk assets.

This the high level view, and we know it is true because it has already taken place.

But exactly how does it play out on the ground?

Commerce will not cease, though it will slow. In the UK, consumer confidence will take a hit, and discretionary purchases will be deferred. UK retail and auto sales will suffer. Businesses will place capital spending plans on hold, including real estate development, as costly projects can always be delayed. Some of this will flow through Europe, the UK's largest trading partner. As a result, the UK economy is expected to fall into recession, and Europe's already paltry growth rate will creep closer to zero.

Beyond that, projections get fuzzy. Economies outside of Europe will feel the aftershocks, but with far less intensity. Economists will try to quantify the fallout, reducing global growth forecasts, but much of it is guesswork.

Then there are the financial market responses.
It is a given that central banks will provide markets with all the liquidity they can offer, yet the effectiveness of this monetary stimulus is debatable. After all, easy money has been the standard policy for nearly a decade, and quantitative easing is still an experimental policy producing questionable results.

In the face of the Brexit vote and UK credit rating downgrades, yields on the UK's 10-year Gilt have fallen 60 basis points, sitting at well under one percent today. That means one strange twist in this saga is a flight to safety, away from UK-based risk, with the UK government seen as less credit worthy; yet the money somehow flows right back into UK government bonds.

Global bond markets have responded in kind. Yields on the US 10-year Treasury have fallen to record lows, now under 1.40 percent. In Germany, Switzerland, and Japan, 10-year notes offer negative yields. This means investors are paying to lend money for a decade. Call it what you want, it is not healthy.

The process of leaving the European Union takes two years at a minimum. The world will not shut down through 2018. The greater threat is that the UK vote sets off a chain reaction of anti-global, anti-European Union policies; or that the European banking system cracks, opening another round of financial system contagion.

And for investors, along with all the other uncertainties, these questions linger: Will all risk premiums rise? Or will capital flow to where it is treated best -- initially in terms of asset classes, but later moving to regions and nations -- out of Europe and into the US, Asia, and other parts of the world?

While far from certain, this latter scenario seems most likely. Stay tuned.

Debating Wall Street's Value

In a recent letter to the Wall Street Journal, Vanguard Group founder John Bogle, challenged the idea, put forth by Harvard Business School Dean Nitin Nohria, that "Wall Street remains a value-creating enterprise."

According to Mr. Bogle:

> "Raising equity in the form of IPOs and secondary offerings for our nation's corporations is a valuable economic activity that fosters economic growth.
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> But the proportion of Wall Street's activities that involves equity capital formation is minuscule. According to Sifma, equity underwritings totaled $256 billion during 2015, while the volume of stock trading totaled $48.6 trillion. So trading by speculators and investors represented 99.5% of this total activity on Wall Street.
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> What does all this trading activity accomplish? It diverts to Wall Street a portion of the stock-market returns created by American corporations. For investors as a group, the attempt to beat the market through trading is inevitably a zero-sum game before costs, and a 'loser's game' after deducting the high costs of all those transactions. In economic terms, trading is a 'rent-seeking' function which subtracts value from Wall Street's customers.
>
> The fact is that, on balance, Wall Street hasn't created value in the past and won't create value in the future."

Two thoughts come to mind.

Back in 2007, just as the housing bubble was beginning to burst, there was a projection that even if the housing market collapsed, it would not reach crisis level. The reason was that home building was barely more than a sliver of our economy. Indeed, even at its peak, new home sales were outnumbered by existing home sales by a ratio of five to one. Furthermore, it was noted, most Americans' net worth was held in other assets, namely stocks and bonds, insurance and pension plans, along with commercial real estate. So a loss in home equity values, while painful to many, would be far from catastrophic. And few homeowners ever need to sell.
Ooops. That didn't work out too well.

Sometimes numbers lie, even accurate numbers.

Now back to Mr. Bogle's statement, "The fact is that, on balance, Wall Street hasn't created value in the past and won't create value in the future."

For argument's sake, let's ignore the non-trading functions of Wall Street -- custodial services, investment research; money management; investment banking including mergers and acquisitions advice; legal, accounting and regulatory support, among others -- and focus on Wall Street's trading activity, the part that seems to draw Mr. Bogle's ire.

Consider this: It is ill-advised, yet not uncommon, for investors to purchase a non-public Real Estate Investment Trust (REIT), with virtually no liquidity. Once you buy it, you are left with an ownership interest that does not trade. Essentially, you are stuck with it.

Or you can buy a publicly-traded REIT, which complies with all Securities and Exchange Commission regulations, including legal, accounting, and disclosure standards; and which offers enough liquidity to sell your entire position in a day or two. All else equal, which one will you pay a premium to own?

It is not the going public that creates value, it is the being public. Apply the same concept to all businesses. Value added.

Tidbits..

Abbott Labs to acquire St. Jude Medical for 25 billion dollars.
Germany's Bayer offers to acquire US agribusiness giant Monsanto for 62 billion dollars.
Microsoft agrees to buy LinkedIn for 26 billion dollars.

In sluggish global economy, companies pull acquisition lever to drive growth.

Share buyback activity within S&P 500 companies hits record level, exceeding 2007 mark.

The second growth lever.

Negative interest rates estimated to total over 11 trillion dollars of debt securities worldwide.
US Treasury yield curve moves to flattest level since 2007.
Yield on US 10-year, 30-year Treasury bonds drop to record low.
Strange but true: with negative interest rates, some European homeowners begin receiving interest income on their adjustable rate mortgages.

Department stores and mall-based retailers suffer as Wal-Mart, Amazon become top two US apparel retailers.

Hard to see this trend reversing.

New home unit sales rise to highest level since 2008.
Existing home sales rise to highest level since 2007.
Median new home prices hit record level.
Wells Fargo initiates mortgage lending program with down payment of three percent.

Do bankers ever learn?

Volkswagen agrees to 15 billion dollar US settlement over diesel emissions scandal.

Swiss voters turn down proposal for 30,000 Swiss Franc minimum income, regardless of employment or wealth status.

A rare case of restraint from 'free' money.

California overtakes Brazil and France, becomes world's sixth largest economy.

Phone book publisher Dex Media enters bankruptcy for third time.

Time to cry 'uncle'.

Philadelphia approves 'sugar tax' on soft drinks, including those without sugar.

Time to just cry.

Source:
Bloomberg
Credit Suisse
Europe.eu
The Wall Street Journal
Wikipedia